MEETING SUMMARY NOTES

Finance Work Group

January 8, 2003
3:30 p.m., Mayor's Conference Room, County-City Bldg.

MEMBERS: Present - Brad Korell, Lowell Berg, Tom Schleich, Larry Zink, Ron Ecklund, Otis Young, Keith Brown, Jim Budde, Mark Hesser, Connie Jensen, Kent Seacrest, Tim Thietje, Dan Marvin, Roger Severin, Terry Werner, Polly McMullen, Richard Meginnis, Allan Abbott (nonvoting)
Absent: Bob Hampton

OTHERS: Kent Morgan, Roger Figard, Jon Carlson, Steve Masters, Margaret Remmenga, Randy Hoskins, Bill Giovanni, Don Herz, Randy Wilson, Gary Brandt

AGENDA ITEMS DISCUSSION:

1. Welcome - Brad Korell, Work Group Chair

Brad Korell brought the meeting to order at 3:30 p.m. by welcoming those present. He then reviewed the agenda with the work group.

2. Meeting Summary Notes - December 12, 2002

Mr. Korell asked if there were any changes in the "Meeting Summary Notes" from the December 12, 2002 meeting. None were suggested.

3. Public Comment Period

Mr. Korell asked if there were members of the public present who would like to address the Work Group at this time. There were none.

4. Water and Wastewater Enterprise Funds Sources & Uses and Peer Cities Comparison Request - Margaret Remmenga

Mr. Korell asked Margaret Remmenga to summarize the financial information for the water and wastewater growth needs for the community. Ms. Remmenga quickly reviewed the baseline funding sources and uses projections for the water enterprise fund. Starting with fiscal year 2002-03 for water, as of August 31, 2002, the end of year cash balance was identified as ($3,691,043). We are projecting $21,451,000 in new revenue from water sales. This takes into account the 7% increase in user fees that was passed by the City Council. Total revenue sources for FY 2002-03 totaled $38,909,957. For uses, we have operating and maintenance costs of $12,105,852; debt service requirements of $4,995,075; capital replacements, which are basically those items that have a life left of 15 years, has a balance of $2,043,000; Capital improvements has a balance of $5,307,000. For any of the revenue for water sales for future years, that is status quo. The only increase would be a 1% increase based on what we have been historically experiencing. Our expenses are escalated at 1.5% which represents the population growth. That does not take into account any inflation that we might experience in future years. Mr. Korell asked if that increase was on the operation and maintenance costs. Ms. Remmenga clarified that operation and maintenance costs are inflated at 1.5% and capital improvements are in today's dollars. Ms. Remmenga asked the members to notice the total gaps that were identified in each fiscal year. I t was asked why in the first year, capital improvements are approximately $5 million, then we see a $10 million jump in FY 2003-04, and then it stays close to $10 million for the next two years. Nick McElvain stated that $5 million is not the appropriated amount for the first year. Ron Ecklund posed the question that the capital improvements are different than a previous worksheet. Allan Abbott stated that those projections did not include category 5. Ms. Remmenga stated that it was done at the time the capital improvement plan was put together and it was before we put together the budget for the current year. It was asked how they handled the 7% rate increase for water in the new revenue forecast. Ms. Remmenga stated it is based on the total projected consumption by different classes, by different rates in those classes, and half of the year is figured at the old rates and half if figured at the new rates.

Mr. Korell stated that he believes that the integrity of the numbers is good. Kent Seacrest inquired about reviewing the assumptions again. Mr. Korell agreed that is a good idea, and we will get the assumptions in writing and distribute them to the members. Mr. Korell reviewed the second sheet showing Category 5 which used the same process, except the expenditures were accelerated. The third and fourth sheets showed the wastewater fund and stated that, again, the format is the same as for water.

Larry Zink stated that he is assuming that at the end of 7 years, we are essentially at the same place. Allan Abbot stated that no, there is a little more in place in Category 5 than in the baseline. Kent Seacrest inquired about whether staff had the ability to estimate how we would cover the gap. Allan Abbott stated that we have raw numbers. The philosophy is that as far as standards are concerned, we are looking at the size of the city now, and asked what it is going to take to spend to bring the plants up to the new standards that are coming. Any replacement of existing mains or repair of existing system is due to "other", it is not growth. Growth is the extension of the plant because of capacity, etc. Mr. Abbott stated that he wants a chance to review these numbers and then distribute them. Mr. Korell stated that we have to make some fairly broad assumptions.

Mr. Korell then stated that he had asked Ms. Remmenga to look at some scenarios. Ms. Remmenga stated that they looked at a scenario for water revenue representing the 7% user fee increase for FY 2002-03 and then a 3% increase for five years. The operating costs that were used were only escalated at 1.5% to represent population growth and does not include inflation. She stated that they were trying to see how much revenue that would bring in and what would be the maximum bonding that we could do under the new bond covenants. She stated that Bill Giovanni would be addressing that issue further. Mr. Korell stated that this was offered just as a starting point for discussion.

5. <u>Lincoln's Overall Debt Position and Financing Capacity - Bill Giovanni</u>

Mr. Korell introduced Bill Giovanni, who has been the President and Chief Executive Officer of Ameritus Investment Corp since 1996, and is the financial advisor for the City. Mr. Korell asked Mr. Giovanni to describe his role as financial advisor. Mr. Giovanni responded that the role is limited in scope to working with the city in terms of rasing capital for capital improvement projects in the issuance of bonds.

Mr. Giovanni distributed two spreadsheets, one for water and one for wastewater, which reflect the 12-year projections. He stated that he will only deal with Category 5 because the cost differentials between baseline and Category 5 are not very significant. And since category 5 is a little more aggressive, he is suggesting to start with category 5.

Mr. Giovanni stated that the conclusion that he has reached is that the water and wastewater system needs as outlined in the 12 year plan can be satisfied by the water and water system over that 12 year period. This requires some major assumptions, and he continued by reviewing those assumptions as follows:

1. It does include an estimate of an allocation of impact fees for the water system and the wastewater system.
2. It also is reflective of the rate increases as follows: for the water system, a 7% rate increase is in place with 3% rate increases for 5 years; for the wastewater system, a 7% rate increase next year and 3% rate increases for the next 4 year.
3. It also assumes a significant increase in the use of revenue bonds for both systems. The bonds that will identify can be issued under the existing bond convents, which will require a minimum coverage of 1.25, not 1.5, as we were successful in lowering the coverage requirement.

Mr. Abbott reiterated that with the assumptions, the cost did not include inflation. Therefore, when inflation gets added, rate increases will go up accordingly. Mr. Giovanni stated that we definitely need to keep that in mind and that there is a big unknown which is how future inflation rates affect these projection.

Mr. Giovanni directed the group's attention to the shaded box on the worksheet showing the water system cash flow projections; that number is $154,029,0178, which is the amount of capital improvements that can be financed with bonds which we are forecasting at $127,000,000 over this 12-year period which meets the 1.25 times coverage test. On a cash flow basis, the system should be able to support $27,000,000 of capital improvements on a "pay as you go" basis. The far right-hand column entitled CIP Costs Category 5 of $160,543,000, which is identified needs. To say there is a $6 million gap over a 12-year period, considering all the assumptions, there is not that level of precision.

Mr. Giovanni stated that he would like to spend most of the time on the water, as the wastewater format is exactly the same as water. Starting with the columns, the *Annual Consumption* column is based on estimated consumption of a baseline number that the utility estimates as their consumption for 2002-03. Increase in growth is by 1% per year. The *Revenue from Water Sales* is simply the usage times the rate structure. This assumes a 7% rate increase in 2002-03 and increases of 3% for the next 5 years. Operating Costs have been inflated at 1.5% per year. Therefore, when we talk about this 1.5%, that is really a real cost increase, with no inflation factored in. The usage is reflective of the fact that as rates have gone up, there has been conservation. *Net Operating Revenue* is simply the difference between revenues and operating costs. *Projected Impact Fees* and *Interest Income*, from an accounting standpoint, are treated as non-operating income. *Interest Income* is clearly not a precise number, but in the whole scheme of things, it will not make a big difference. When you add the operating revenue with the non-operating income, you have Revenue *Available for Debt Service*. The *Series 2002 Debt Service Requirement* is a factual number and is debt service on the bonds that currently exist. The 2002 bonds that were issued actually refunded bonds originally issued in 1991 that had a final maturity of 2011. The $18.8 million that was issued was new money which has a new 20-year amortization. So if you look at this column, you'll see that debt service going forward is $6.2 million until you get to 2011. Starting in FY 2012, all you are paying is the debt service on the $18.8 million. From a financial planning perspective, this is good because there is additional debt capacity built in here, as you can starting plugging that hole with additional debt service without increasing rates. *Additional Bonds Debt Service Requirement* is a cash flow estimated debt service requirements on bonds that are issued in three series. Tax law limits municipalities to not issue more bonds than they need in terms of spending requirements over a three year period, which is a reasonable expectation.

Mr Giovanni stated that he used an amortization schedule of 25 years. The average life of the assets is much longer than 25 years. When you add the 2002 debt service requirement to what is projected, you get the debt service coverage ratio, which is simply the division between what the revenue available for debt service is divided by the total amount of debt service. At the time you issue bonds, you have to meet the 1.25 test. *Additional Debt Service Coverage*, in 2004-05, is 1.4404. The .44 is real cash, it is revenue available for debt service that isn't needed for debt service. What is the .44 available for? It is available for *Capital Replacements,* which is equipment and shorter-lived assets, which is really an operating cost, in his opinion. In *Operating Coverage*, we have assumed that we are going to manage the system so that the cash receipts equal the cash disbursements. You can see the cash that is available for capital improvements on a "pay as you go" basis will range from $4.3 million, then decline and build back up. There is $27 million of capital improvements that can be funded on a "pay as you go" basis, per these assumptions. Again, *End of Year Cash Balance,* we have left flat at the $10,236,124, which is the forecast for the cash balance as of the end of FY 2002-03. The second to the last column is *CIP Costs Category 5,* the capital improvement costs identified in the Comprehensive Plan per Category 5. The last column reflects what the cash availability is to fund capital improvement projects after you have issued the bonds. As you spend those bond proceeds down, you can see you get down to $5.4 million, which is less than one year's worth of capital improvement; therefore, you better start issuing more bonds. That is how we end up with a 3 year cycle of bonds.

Mr. Giovanni posed the question, can the system handle this amount of additional debt. The answer, in his opinion, is yes. He believes that the city is very blessed in that our balance sheet is under-leveraged. Mr. Giovanni stated that if we get to a point where we want to accelerate or anticipate an acceleration in growth, we are in a good position to do that.

Mr. Giovanni stated that everyone should be able to see how he drew his conclusion that the system requirements, pursuant to the Comprehensive Plan, are salvable. Mr. Giovanni wanted to reiterate the point that everyone shouldn't walk away from this meeting saying that all we need is five more rate increases.

Mr. Ecklund stated that he was truly elated to see this, and that we have come a long way since we first started these meetings. He also stated that he has some mixed emotions, because a couple months ago, he did some financial projections to see if we could do this without impact fees. Then he was given these projections and revised his spreadsheets using these projections, so he is wondering how these numbers on the costs keep changing in the last two months. He stated that he didn't see this as a compelling argument for impact fees at this point in time. Mr. Korell stated that this would be part of the discussion in the next meeting. Mr. Abbott stated that the Category 5 map "changed the world", so anything before then, you can forget about.

Mr. Seacrest posed the question, is this the maximum to retain the highest bond rating that the city presently enjoys. Mr. Giovanni answered that this basically solves for the maximum amount that you can issue under the existing ordinance, without regard to any impact to the rate. Keith Brown stated that basically what the bond rating agency is going to look at is the ordinance; what provisions are in the ordinance to protect, #1, the bond holders; and #2, to provide sufficient revenues to support the needs of the organization. This will make the rating agencies a little nervous, but they also recognize the projection we have worked through to the end. He stated that his guess is that an aggressive capital program is not going to harm Lincoln's very good bond rating.

Connie Jensen asked that in a worst case scenario, we do slip one notch on our credit rating, what will that do to the overall net cost of these $127 million bonds. Mr. Giovanni stated that we have a AA rating now, and couldn't believe that we would drop to A. At any point in time, there are differences in spreads between high grade and lower grade, but his guess would be 50 basis points.

Mr. Korell asked Mr. Giovanni to distribute the wastewater sheets. In the meantime, Terry Werner asked the question as to how would that affect the numbers without the revenue source of the impact fees. Mr. Giovanni stated that it would impact it, because it would reduce the total amount of revenue that would be available for debt service. He stated that he could quantify it at some point in the future, but you would not be able to issue $127 million in bonds. Mr. Korell stated that we could drop that column and compute the gap.

Mr. Giovanni stated that he approached the wastewater the same way as for water. You can see, what we figured we can solve for if we have $143 million capital improvement costs, $115 million in bonds, $28 million in cash, cash being capital improvements paid for on a "pay as you go" basis, Category 5 needs are identified at $158 million. So there is a little more of a gap, so to speak, but again, 12 years is a long time when you're making these type of projections. But you can see that we have come to the same kind of conclusion.

Mr. Ecklund commented that we're talking about bond issuances of $127 million and $115 million, and that when he first started his projections, his projections were even less than this, and the reaction was that he was completely wrong. Mr. Abbott stated that his projections were without rate increases and without including operating and maintenance costs. Mr. Korell stated that we haven't reached any decision yet and that we are addressing concepts only at this point.

Dan Marvin asked if there are any economies to scale. Mr. Giovanni stated that these are closed systems which really protect the bond holder, so that the revenues that are derived from the system can only be used for system improvements or uses. Therefore, funds out of the wastewater system cannot be used for general fund purposes, for example. Mr. Ecklund stated that you can transfer between the two. The question was asked, can new bond indentures be written differently? Mr. Giovanni responded that some smaller communities have combined utility systems, but as you get larger in scale, it is customary to have individual systems. Mr. Abbott stated that in regard to the transfer issue, funds are not transferred. Ms. Remmenga confirmed what Mr. Abbott said.

(The mechanical recording device experienced technical problems at this point in the meeting. A portion of the discussion was lost.)

6. <u>Water and Wastewater Balance Sheets - Don Herz</u>

(While no audio record is available for this portion of the meeting, it can be noted that Don Herz distributed balance sheets for both the water and wastewater system. He reviewed various aspects of the balance sheets and the conditions under which they were produced, including the use of cash flow projections tying projected balance sheet and income statements. Mr Herz also noted that the sheets were constructed using an accrual basis. Brad Korell drew attention to two lines (i.e., "Revenue Bonds Payable, noncurrent" and "Total Fund Equity") and said that the members should look at how the ratio of those two lines compare over time. These can be indicative of the City's ability over the long term to issue additional bonds. After reviewing the balance sheets, Mr. Korell asked Mr. Herz if there is anything in the balance sheets that would lead him to a different conclusion than Mr. Giovanni. Mr. Herz stated that the balance sheets help to prove and support Mr. Giovanni's conclusion.)

(Audio tape clarity resumed.)

Mr. Korell mentioned that Black & Beach engineering has done a comparability study on what communities pay for their utilities. Ms. Remmenga will give those numbers to the engineer to get a benchmark on our rates and possibly validate our conclusions. Ms. Remmenga stated that she will call them tomorrow, but warned the group that this study is like comparing apples to oranges.

Mr. Giovanni stated that the city currently enjoys a AAA bond rating, the highest rating possible. He stated that in getting the rating, they look at the vitality of the community, the stability of the community, unemployment rates, but the economy is probably the main driver. They make an assessment as to the quality of the management team, which is a judgement decision. The city has a very low debt burden as measured as a total of valuation. Mr. Giovanni stated that we have an under leveraged debt burden. He then posed the question as to how much more can be issued, and stated that he can't tell you.

Don Herz then handed out information showing a range of statistics for cities with AAA bond ratings.

(Audio tape problem reoccurs. The balance of the meeting discussion was lost.)

7. Municipal Financing Summary - Keith Brown

(At Brad Korell's request, Keith Brown summarized his work with a national municipal financing organization. This discussion generally included such topics as the economic life of utility equipment, the appropriate length (i.e., years) for bond terms, bonding for rehabilitation work, and other related topics. Mr. Brown noted that he would make copies of various articles concerning bond rating standards available to the work group members.)

8. Other Business

The next meeting will be on January 22, 2003 at 3:30 p.m. in Room 113 of the City-County Building.

9. Adjournment

Mr. Korell adjourned the meeting at 5:25 p.m.

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